MULTISTATE TAX COMMISSION

MEMORANDUM

To: Robynn Wilson, Chairperson,
Income and Franchise Tax Uniformity Subcommittee

From: Bruce Fort, MTC Counsel

Date: November 4, 2011

Re: Further Study Suggestions for Amendment of "Subject to Tax" Model Allocation and Apportionment Regulations Applicable to the "Taxable in Another State" Provisions in Multistate Tax Compact Article IV.3.

On July 25, 2011, the Income and Franchise Tax Subcommittee considered a project to study possible amendments to the model regulations addressing the "taxable in another state" provision of the Multistate Tax Compact, Article IV.3. The topic was discussed again by the Subcommittee in a teleconference held on September 6, 2011. At the September teleconference, several members suggested that the topic may not be ripe for a project by the subcommittee since it was not clear that the current regulations were inadequate. A motion was passed to defer further consideration until the states had an opportunity to assess problems with the current regulations. ***The item was placed on the agenda for this meeting with a request that the subcommittee members ask their legal and auditing staffs to comment on their experiences under the current statute and regulations so the subcommittee can decide whether to continue with the project in whole or part.***

Twenty six states[1] currently have apportionment systems that require, for purposes of determining the numerator of the sales factor, the "throw-back" of sales to the state of shipment when the taxpayer is not "taxable" in the destination state. See Multistate Tax Compact, Article IV.16.(b). Compact Article IV.3 defines "taxable in another State" as follows:

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[1] Alabama, Alaska, Arkansas, California, Colorado (limited), District of Columbia, Hawaii, Idaho, Illinois; Indiana; Kansas, Kentucky (for sales to U.S. gov't only), Maine, Massachusetts, Mississippi, Missouri, Montana, New Mexico, North Dakota, Oregon, Rhode Island, Tennessee (limited to sales to U.S. gov't), Utah, Vermont, West Virginia and Wisconsin.

> For purposes of allocation and apportionment of income under this Article, a taxpayer is taxable in another State if (1) in that State he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that State has ***jurisdiction*** to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so.

The purpose of throw-back provisions of the Compact is to ensure the full apportionment of multistate taxpayer's income so that those businesses do not enjoy an unfair tax advantage over business that confine their operations to a single taxing jurisdiction.

Two central problems with the administration of sales throw-back have been identified and discussed in prior meetings:

- Taxpayers could potentially avoid throw-back by payment of a minimal amount of franchise or capital stock tax in the destination state;

- Taxpayers could take inconsistent positions in "shipment" and "destination" jurisdictions, filing returns in the shipment state excluding destination sales from the numerator, contending it was subject to tax in the destination state, while claiming to be immune from taxation on returns filed in the destination state, resulting in "no-where" sales factor apportionment.

The current model regulations do include some provisions which address both potential problems. See attachment A for the full language of the model regulations. The question before the subcommittee is whether these regulations should be changed to ensure that the full apportionment purposes of Article IV.16.(b) are being met.

A. The "Minimum Tax Payment" Problem.

Currently, Model Regulation IV.3.(b)(1) & (2) provides three restrictions on taxpayers' ability to avoid throw-back by payment of a minimal tax in the destination state: (a) the voluntary payment of an income, franchise or capital stock tax does not qualify as being "subject to" taxation; (b) where the taxpayer's activities are insufficient to create income tax nexus and the franchise or capital stock tax "bears no relationship to the extent of business activity" conducted in the state, and (c) the franchise or capital stock tax paid must be "…basically revenue raising rather than regulatory measures."

Example (4) to Regulation IV.3.(b) suggests that payment of minimum amounts of income or income-based franchise tax would prevent the "throw-back" of sales to the origination state. (This would also be the result under Article IV.3's "jurisdiction to tax" test applicable to sales to states which do not impose an income tax.)

The Subcommittee may wish to consider if additional regulatory interpretation of Article IV.3 would be appropriate if it is presented with information suggesting that income is

being under-apportioned as a result of payment of minimal franchise or similar taxes in destination states.

B. The Problem of Inconsistent Reporting of Being "Subject to Tax" in the Destination State.

The subcommittee did not discuss this issue in its meeting on September 6, 2011. There have been reported instances of taxpayers filing amended returns in the origination state seeking to reverse earlier throw-back positions, claiming they were actually taxable in destination states even through no income taxes were paid in those states. *See, e.g., Colgate Palmolive Co. v. Comm. of Rev.,* Mass. App. Tax Bd. No. C255116 (4/23/03), 2003WL1787975,http://www.mass.gov/?pageID=afsearchlanding&sid=Eoaf&q=colgate-palmolive&collectorName=EOANFxDECISIONSx.[2]

Regulation IV.3.(b).(1) provides that the tax commissioner can request copies of returns filed in the destination state as proof of being taxable in that state, and that the failure to provide such returns "can be taken into account" in determining whether the taxpayer has met its burden of demonstrating that it was subject to tax in the destination state.

The subcommittee may wish to consider whether it would be appropriate to adopt an absolute requirement for proof of payment of taxes in the destination states (or sourcing the disputed sales to those states on a combined report) in order for the taxpayer to claim to be subject to those states' taxing jurisdiction, as some states have done.[3] Of course, allowance would have to be made for situations where a state has jurisdiction to impose a tax under the Constitution and statutes (e.g., Public Law 86-272) of the United States, but has chosen not to. Under Article IV.3.(2) and MTC Reg.IV.3(c), these situations do not require throwback, even though no tax payment is made.

It is hoped the states will be able to provide information on how often taxpayers have taken inconsistent positions in order to avoid throw-back of income and whether a more definitive requirement for demonstrating filing and payment of taxes in the destination state would be beneficial.

The subcommittee is encouraged to review prior memorandums on this topic dated July 14, 2011 and August 26, 2011 for further background. Those memoranda are posted with these materials.

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2 *See also, Goldberg v. State Tax Commission*, 618 S.W.2d 635, 642 (Mo. 1981)(failure to file return immaterial to issue of whether taxpayer subject to tax in destination state); *Indiana D.O.R. v. Continental Steel Corp.*, 399 N.E.2d 754, 758 (Ind. App. 1980)(same).

3 *See Dover Corp. v. Dept. of Revenue*, 648 N.E.2d 1089 (Ill. 1995) (failure to file returns precludes argument that taxpayer subject to tax in destination state); *In re Appeal of Galvatech, Inc*., 2006 WL 29531 (Cal. SBE 2006)(failure to demonstrate that taxes were paid precluded claim that taxpayer was subject to tax in foreign jurisdictions

Attachment A –

Current MTC Model Regulations Defining "Taxable in Another State"

••• Reg. IV.3.(a). Taxable in Another State: In General. Under Article IV.2. the taxpayer is subject to the allocation and apportionment provisions of Article IV if it has income from business activity that is taxable both within and without this state. A taxpayer's income from business activity is taxable without this state if the taxpayer, by reason of such business activity (i.e., the transactions and activity occurring in the regular course of a particular trade or business), is taxable in another state within the meaning of Article IV.3.

(1) Applicable tests. A taxpayer is taxable within another state if it meets either one of two tests: (1) By reason of business activity in another state, the taxpayer is subject to one of the types of taxes specified in Article IV.3.(1), namely: A net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) By reason of such business activity, another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not the state imposes such a tax on the taxpayer.

(2) Producing nonbusiness income. A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in that other state pertaining to the production of nonbusiness income or business activities relating to a separate trade or business.

••• Reg. IV.3.(b).Taxable in Another State: When a Corporation Is "Subject to" a Tax under Article IV.3.(1).

(1) A taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) if it carries on business activities in a state and the state imposes such a tax thereon. Any taxpayer which asserts that it is subject to one of the taxes specified in Article IV.3.(1) in another state shall furnish to the [tax administrator] of this state upon his/her request evidence to support that assertion. The [tax administrator] of this state may request that such evidence include proof that the taxpayer has filed the requisite tax return in the other state and has paid any taxes imposed under the law of the other state; the taxpayer's failure to produce such proof may be taken into account in determining whether the taxpayer in fact is subject to one of the taxes specified in Article IV.3.(1) in the other state.

Voluntary tax payment. If the taxpayer voluntarily files and pays one or more of such taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization or for the privilege of doing business in that state, but

(A) does not actually engage in business activity in that state, or

(B) does actually engage in some business activity not sufficient for nexus and the minimum tax bears no relationship to the taxpayer's business activity within such state, the taxpayer is not "subject to" one of the taxes specified within the meaning of Article IV.3.(1).

Example: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return and pays the $50 minimum tax, although it carries on no business activity in State A. Corporation X is not taxable in State A.

(2) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes enumerated in Article IV.3.(1) which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) in another state.

Example (i): State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of $50 and a maximum fee of $500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not "taxable" in State A.

Example (ii): Same facts as Example (i) except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is "subject to" the net income tax of State A and is "taxable" in State A.

Example (iii): State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is "taxable" in State B.

Example (iv): State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a

return based upon its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax.

••• Reg. IV.3.(c). Taxable in Another State: When a State Has Jurisdiction to Subject a Taxpayer to a Net Income Tax. The second test, that of Article IV.3.(2), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-385. In the case of any "state" as defined in Article IV.1.(h), other than a state of the United States or political subdivision thereof, the determination of whether the "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state." If jurisdiction is otherwise present, that "state" is not considered as being without jurisdiction by reason of the provisions of a treaty between that "state" and the United States.

Example: Corporation X is actively engaged in manufacturing farm equipment in State A and in foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.